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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 645

THE ST. LOUIS COMPANY, A DELAWARE CORPORATION
(IN DISSOLUTION)

Petitioner,

vs.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, THIRD CIRCUIT

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TO THE HONORABLE, THE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

The Petitioner, The St. Louis Company, a Delaware corporation (in dissolution), prays that a writ of certiorari issue to review a final decision of the United States Court of Appeals, Third Circuit, reversing a decision of the United States District Court for the District of Delaware.

OPINION AND JUDGMENT BELOW

The opinion and judgment of the United States Court of Appeals, Third Circuit, is reported at 237 F. 2d 151, and is

attached as "Appendix A" to this Petition. The opinion and judgment of the United States District Court for the District of Delaware is reported at 134 F. Supp. 411 and is attached as "Appendix B" to this Petition.

JURISDICTION

The decision of the United States Court of Appeals, Third Circuit, was entered on September 24, 1956. The jurisdiction of this Court is invoked under the Act of June 25, 1948, c. 646, 62 Stat. 928, 28 U. S. C., Section 1254.

QUESTION PRESENTED

Is a personal holding company, which liquidated completely and distributed all of its assets to its stockholders on or about June 18, 1948, liable for the penalty tax of 75% — 85% upon its "undistributed subchapter A net income", imposed by Section 500 of the Internal Revenue Code of 1939, for its fiscal year which ended June 30, 1948?

STATUTES, REGULATIONS AND RULINGS INVOLVED

The statutes, regulations and rulings involved are lengthy and are set forth verbatim in "Appendix C" to this Petition. They are as follows:

Rev. Code of 1939—
- Section 27(a)(1);
- Section 27(b)(1);
- Section 27(g);
- Section 115(a);
- Section 500;
- Section 504;

Regulations 111, Section 29.115-1;

Income Tax Ruling 3067, 1937-1-C. B. 91.

STATEMENT OF CASE

All of the facts are stipulated and may be summarized as follows:

On or about July 1, 1948, Petitioner, The St. Louis Company, a Delaware corporation, filed in the office of the Collector of Internal Revenue at Wilmington, Delaware, its Federal Personal Holding Company Tax Return under subchapter A, Chapter 2 of the Internal Revenue Code of 1939,* for its fiscal year which began on July 1, 1947, and ended on June 30, 1948, and paid the taxes shown thereon to be due. The Commissioner of Internal Revenue made certain adjustments in the computation of the tax and determined a deficiency of $31,540.29 in the amount of the alternative tax due from the Petitioner for the said fiscal year. Pursuant to this determination by the Commissioner, an additional tax was assessed in the amount of $31,504.29, plus interest in the amount of $3,583.49, and these sums were paid by the Petitioner to the Collector of Internal Revenue at Wilmington, Delaware, on September 15, 1950.

The Petitioner duly filed a claim for refund for the return of the above amounts, which claim for refund was disallowed on March 30, 1951.

The Petitioner thereupon instituted suit in the United States District Court for the District of Delaware on March 20, 1953. Jurisdiction of the United States District Court for the District of Delaware was invoked under Title 28 U. S. C., Section 1346(a)(1). On September 15, 1955, final judgment was entered by the United States District Court for the District of Delaware in favor of Petitioner and against Respondent in the sum of $35,123.78 with interest.

* All references as to "Code" or to "Internal Revenue Code" are, unless otherwise noted, to the Internal Revenue Code of 1939.

A timely appeal was taken by the Respondent to the United States Court of Appeals for the Third Circuit which entered a judgment reversing the decision of the United State District Court for the District of Delaware.

The dispute between the Petitioner and the Respondent arose in the following manner: — From July 1, 1947, to June 18, 1948 (the date of its dissolution), the Petitioner had net income, as defined in subchapter A, Chapter 2, of the Internal Revenue Code, in the sum of $37,766.62. On June 18, 1948, Petitioner was dissolved under the laws of the State of Delaware and thereafter (but prior to June 30, 1948) Petitioner distributed all of its assets, which were in excess of $37,766.62, to its sole stockholder. This was the only distribution made by the Petitioner to its stockholder during the fiscal year in question.

Petitioner claimed a dividends-paid credit against its subchapter A net income in the amount of $37,766.62, being the exact amount of its net income and less than the amount distributed to its stockholder as a liquidating dividend. It, therefore, computed its undistributed subchapter A net income as zero.

The Commissioner disallowed in full the asserted dividends-paid credit of $37,766.62, resulting in a tax claim of $31,548.79.

At the beginning of the Petitioner's fiscal year, July 1, 1947, it had a deficit of $121,436.24 and on the date of its dissolution, June 19, 1948, it had a deficit of $82,001.86.

REASONS FOR GRANTING THE WRIT

1. The decision of the Court below is in direct conflict with the decisions of the United States Court of Appeals for the Second Circuit on the same matter in the case of *Pembroke Realty and Securities Corp. v. Commissioner,* 122

F. 2d 252, and the case of *Brooklyn National Corp. v. Commissioner*, 157 F. 2d 450. This fact was recognized by the Court below in its opinion at 237 F. 2d 155, 156.

The Court below has decided an important question of Federal law which has not been, but which should be, settled by this Court.

ARGUMENT

The basic issue in this case is whether, in interpreting the tax laws of the United States, the intent of Congress should be determined by viewing the Internal Revenue Code as a whole in the light of tax economics or whether, on the contrary, the intent of Congress should be determined by a microscopic examination of specific sections of the Code without regard to the uneconomical and unrealistic result which such a method develops. This Court has consistently adopted the first approach in such land-mark cases as *Gregory v. Helvering*, 293 U. S. 465 and *Helvering v. Clifford*, 309 U. S. 331.

As to the precise point here involved, the Second Circuit has also adopted the broad, economic method of interpretation in *Pembroke Realty and Securities Corp. v. Commissioner*, 122 F. 2d 252; whereas, the Court below, it is submitted, has adopted a narrow view of reliance upon literal interpretation of the phraseology of specific sections of the Code. It is this fundamental difference of method of interpretation between the two Circuits which Petitioner asks this Court to resolve.

The tax in dispute is upon the "undistributed subchapter A net income" of a personal holding company (Section 500 of the Code). The key word in this phrase, upon which the decision of this case rests, is the word "undistributed". There is no doubt as to the fact that the Petitioner, in

proper time, distributed everything it owned to its stockholder by way of a liquidating dividend. This, it is respectfully submitted, should be the end of the matter. There can, economically, be no such thing as a tax on undistributed income in a situation where everything which the taxpayer owns, income as well as capital, has been distributed. This is the view of the Second Circuit as expressed in the *Pembroke* case, supra. It is also the view of all the United States District Courts, which have considered the matter. *Piper v. United States* (District Court of Minnesota) 50 F. Supp. 363, *Fisher v. Kavanaugh* (District Court of Michigan) 100 F. Supp. 248 and the District Court of Delaware in this case (134 F. Supp. 411). This conflict was recognized by the Court below (237 F. 2d 155, 156). This also is the view of the Respondent himself, as expressed in Income Tax Rulings 3067 (1937-1-CB-91) which ruling was in effect at the time of the distribution involved and, indeed, was in effect until after this suit was brought. The Respondent stated in Income Tax Rulings 3067 that:

> "It is obvious that in the case of a complete liquidation of a corporation no income remains undistributed and, therefore, there is nothing to which the undistributed profits tax is applicable. In this situation it is immaterial whether the prescribed distribution takes the form of an ordinary dividend or a distribution in liquidation."

The Respondent treads a torturous path through the Internal Revenue Code to reach a completely unrealistic and uneconomical result to the contrary and he concludes (and the Court below agreed) that a corporation can liquidate completely and still have something left "undistributed" upon which to base a tax. His argument runs as follows: As stated above, the tax is on "undistributed subchapter A net income" (Section 500). To determine the meaning

of "undistributed" Respondent turns to Section 504 of the Code which provides that in determining the amounts to which the tax applies, there shall be allowed, as a deduction, "the amount of the dividends-paid credit provided in Section 27(a)". The Respondent now examines Section 27(a) and finds therein that "dividends-paid credit" includes the term "basic surtax credit", as defined in Section 27(b). The Respondent then leads us to Section 27(b) where we find that "basic surtax credit" means, *inter alia*, "the dividends paid during the taxable year". To ascertain the meaning of "dividends paid" the Respondent would have us turn to Section 27(g) which states:

> "(g) *Distributions in Liquidation.* — In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid."

The Respondent then argues, without citing a single reference to an authoritative work on economics or accounting, that no distribution can be "chargeable to earnings or be profits" in the case of a deficit corporation until the deficit is made up from earnings, even though the corporation distributes, as a liquidating dividend, all of its assets.

The Court below and the Respondent thus arrive at this amazing result: Corporation A, a personal holding company, begins the year with a surplus of $1.00. It earns $30,000.00 during the year and then liquidates. No tax is imposed. Corporation B, a personal holding company begins the year with a deficit of $30,000.01. It earns $30,000.00 during the year and then liquidates. A penalty tax of 75% on the first $2,000.00 of earnings and 85% on $28,000.00 of

earnings is imposed on the theory that nothing has been distributed.

The Second Circuit in the *Pembroke* case dealt with this absurd proposition as follows, beginning on page 254 of 122 F. 2d:

> "Had Pembroke's capital not been impaired, its distribution of current income would indisputably have been a 'dividend' and the corporation would not have been subject to a surtax. *It is incredible, in the light of the purpose of the legislation, that a different result was intended in the case of a corporation whose capital happened to be impaired.* (Italics supplied.)
>
> "This consequence, however, is said to be inevitable because of the definition of 'dividend' in section 115(a). We do not think so. A dividend is there defined as 'any distribution made by a corporation * * * out of its earnings or profits accumulated after February 28, 1913.' Read literally, the statute would seem to be satisfied by Pembroke's distribution to its shareholders of earnings accumulated during the year ending September 30, 1936. All that stands in the way is the gloss put upon the definition by the ruling that a corporation cannot have accumulated earnings available for a dividend so long as its capital is impaired. Ordinarily that gloss upon the statutory definition may be justified. See *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, 218, 48 S. Ct. 71, 72 L. Ed. 247. We do not think it need be carried over into section 351. To do so results in consequences contradictory to the purposes of that section. It precludes corporate earnings actually distributed to the shareholders from being treated as dividends so as to increase their surtaxes and it penalizes the corporation for doing the very thing the statute was intended to induce it to do. * * * In our opinion the distribution of current earnings should be deemed a dividend within the meaning of section 351, regardless of the fact that the taxpayer's capital was impaired. * * *"

The District Court in this case well exposed the fallacy of this reasoning. It stated (100 F. Supp. at 250):

> "The overriding intent of Congress, it would seem, was, that insofar as personal holding companies are concerned, to compel such companies to distribute the funds on hand and to prevent their accumulation or to compel substantial surtaxes on such accumulation. There seems no discernible intent to discriminate against a company unsuccessful in past years as against one which had had some measure of success, when in both cases the overriding purpose of Congress, viz., the distribution of all funds, is accomplished. As stated in Fisher v. Kavanagh (supra), the position of the taxing authority would seem to achieve a result completely repugnant to the purposes of the Act."

The District Court for the District of Minnesota (*Piper v. United States*), at 50 F. Supp. 365, disposed of this contention as follows:

> "The congressional history of this legislation unmistakably indicates that it was devised to drive the current income of the personal holding corporation to its shareholders. In the instant situation, this was done. That which Congress sought to achieve by the legislation was attained. In effect, however, the Government is now seeking to penalize the corporation for doing that which the statute intended to produce. The fact that the corporation liquidated at the time that the earnings were turned over to the shareholder is immaterial. No cogent reason is suggested in support of any theory which denies the right of the deduction made herein.
>
> "If the Government's position is upheld, we have the anomalous situation of a tax being assessed on the hypothesis that the current earnings never reached the shareholder, when the contrary is true. It may be readily conceded that every complete liquidation does not constitute the payment of dividends. But that assumption does not negate the fact that if, in liquidation, the current earnings reach the shareholder, then

to the extent of such earnings the shareholder has received dividends within the meaning of the present statute. A strict construction is not called for when a common sense construction squares with the plain and obvious intent of Congress."

Entirely separate and apart from the contention that the decision of the Court below should be reversed because of its failure to interpret the will of Congress by reference to the economic realities of the situation, there are other reasons for reversal. These reasons are summarized below and, if this petition is granted, will be elaborated upon, as follows:

1. Even if Respondent's contention is correct, i. e., that this case should be determined by a literal interpretation of specific provisions of the Code, the result is erroneous in that the term "dividend" is not defined, for purposes of this case, by Section 27(g) of the Code, as Respondent contends, but by Section 115(a), which provides in part that:

> "*Definition of Dividend.* — The term 'dividend' when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. In the case of a corporation which, under the law applicable to the taxable year in which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504(c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to

such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income, less the sum of the following:"

Since Section 115(a) specifically refers to personal holding companies, it is controlling, for purposes of this case, over the provisions of Section 27(g) which are of general application to *all* business companies.

2. The Respondent's Regulations, as well as I. T. 3067 referred to above, in effect at the time of the distribution in question support Petitioner's view. Regulations 111, Section 29.115-1 provide, in part, as follows:

"For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distribution made within such year."

"The term 'dividend' also includes any distribution to shareholders to the extent of its Subchapter A net income for the taxable year as hereinafter indicated in which, or with respect to which, the distribution is made, whether or not a dividend as defined in the first sentence of Section 115(a), made by a corporation which, for the taxable year in which such a distribution is made * * * was under the applicable law a personal holding company. * * *."

CONCLUSION

For the reasons set forth above, it is respectfully submitted that the writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

OPINION OF THE COURT

(Filed September 24, 1956)

BY KALODNER, *Circuit Judge*

Where a personal holding company's deficit in "earnings or profits accumulated after February 28, 1913" exceeds its net income for the taxable year is a distribution out of such income, during the taxable year, in complete liquidation of the company, a "dividend" within the meaning of the dividends paid credit provisions of the Internal Revenue Code of 1939, as amended to 1948?

That is the single issue presented by this appeal from the judgment of the United States District Court for the District of Delaware in favor of the taxpayer.

The facts were stipulated and may be summarized as follows:

On or about July 1, 1948, St. Louis Company ("taxpayer") filed in the office of the Collector of Internal Revenue its federal holding company return under Subchapter A, Chapter 2, of the Internal Revenue Code of 1939, for the fiscal year July 1, 1947, to June 30, 1948, and paid the alternative tax shown thereon to be due. The Commissioner, upon auditing the return, made certain adjustments in the computation of the alternative tax and determined a deficiency. An additional tax was assessed, and upon notice and demand for payment, the additional tax in the sum of $31,540.29 with interest from September 15, 1948, in the amount of $3,583.49, was paid by taxpayer on September 14, 1950. A claim for refund having been disallowed, taxpayer instituted this suit in March, 1953. The District Court found for the taxpayer[1] and entered judgment in favor of taxpayer on September 15, 1955 in the amount of $35,123.78, together with interest from September 14, 1950.

The adjustments made by the Commissioner were as follows: taxpayer reported as its net income under Sub-

[1] 134 F. Supp. 411 (D.C. Del. 1955).

chapter A, Chapter 2 the sum of $37,766.62; claimed that amount as a dividends paid credit against the Subchapter A net income; reported its undistributed Subchapter A net income as zero, and returned as its alternative personal holding company tax the amount of $8.50. The Commissioner disallowed in full the asserted dividends paid credit and adjusted taxpayer's undistributed Subchapter A net income to $37,766.62, and computed the taxpayer's alternative tax to be $31,548.79 and its deficiency to be $31,540.29.

The Commissioner based the adjustments upon the financial condition of the taxpayer on or about June 18, 1948 when it dissolved under the laws of Delaware, and all of its assets, which were in excess of $37,766.62, were distributed to the executors of the estate of Simon Dalsheimer, deceased, who were the sole stockholders of taxpayer. There were no other distributions by the taxpayer to its stockholders during its fiscal year ending June 30, 1948. The amount of taxpayer's earnings and profits, after taxes, for the fiscal year was $37,766.62. The amount of the deficit in taxpayer's accumulated earnings and profits on July 1, 1947, was $121,436.24 and on or about June 18, 1948, was $82,001.86.

The surtax on personal holding companies is imposed by Section 500, Subchapter A, Chapter 2 of the Internal Revenue Code upon the "undistributed subchapter A net income" which is defined in Section 504 as the "subchapter A net income (as defined in section 505)" minus several items. "The amount of the dividends paid credit provided in section 27(a) . . ." is the first of these deductible items and the deduction which the taxpayer here seeks to obtain. Section 27(a) defines the "dividends paid credit" to include the "basic surtax credit" which is computed as provided in section 27(b) to include "The dividends paid during the taxable year . . ."

With this scheme of statutory reference both the Government and taxpayer agree, but here their paths diverge in seeking to determine the appropriate statutory direction to what is a "dividend" for purposes of the dividends paid credit.

Taxpayer contends that the term "dividend" as defined in section 115(a) of the Code is controlling[2] because these criteria were present: (1) the distribution was "out of the earnings or profits of the taxable year", (2) any distribution by a personal holding company to its shareholders is a dividend, and (3) the distribution by taxpayer was "out of its earnings or profits accumulated after February 28, 1913" in accordance with the meaning of that phrase declared in Pembroke Realty & Securities Corp. v. Commissioner, 122 F. 2d 252 (2d Cir. 1941). A corporate distribution is a "dividend" for purposes of the dividends paid credit provision, says the taxpayer, under any of the circumstances stated. It further urges that section 27(g)

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[2] Section 115. Distributions by Corporations.

(a) Definition of Dividend. — The term "dividend" when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. In the case of a corporation which, under the law applicable to the taxable year in which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504(c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income. . . .

(b) Source of Distributions. — For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. . . .

(c) Distributions in Liquidation. — Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. . . .

relating to distributions in liquidation[3] is not applicable since that section is of general application and its effect on personal holding companies is nullified by that portion of section 115(a) specifically dealing with personal holding companies.

Finally, it asserts even if Sec. 27(g) is to be deemed controlling, the expansive meaning of "earnings or profits accumulated after February 28, 1913", as declared in the *Pembroke* case, permits allowance of the dividends paid credit.

The Government contends principally (1) the distribution was not a payment of ordinary dividends but a distribution in complete liquidation; and (2) Sec. 27(g) contains explicit direction for computation of the dividends paid credit in such case and since the current earnings of the taxpayer were insufficient to eliminate its existing capital deficit, no part of the distribution is "properly chargeable to the earnings or profits accumulated after February 28, 1913", and, accordingly, the taxpayer is not entitled to the dividends paid credit.

We subscribe to the Government's view.

That Section 115(a) is inapplicable to this distribution is made clear by the legislative history of the "Distributions by Corporations" provisions of Sec. 115. The problem of distinguishing the ordinary dividend distribution from a distribution in liquidation was one inherent in the wording of the early Revenue Acts. See James Dobson, 1 B.T.A. 1082 (1925). The structure of the later Code provisions was established in the Revenue Act of 1924[4] where the definition of "dividend" was distinguished from the treatment of the distribution in liquidation. The provisions of Sec. 115 here in issue are the result of amendments by the various Revenue Acts which emphasized the difference in treat-

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[3] Int. Rev. Code of 1939, Sec. 27(g), 53 Stat. 47, provides:

"In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid."

[4] Sec. 201, 43 Stat. 254.

ment to be accorded the two types of distribution, and it is clear that the distinguishing factor in these corporate distribution provisions is the difference between a distribution made by a going corporation and one made by a corporation in liquidation. Hellmich v. Hellman, 276 U.S. 233 (1928). Thus under Sec. 115(c) a distribution in complete liquidation is treated as a *sale or exchange* with a resultant capital gain or loss in the hands of the distributees despite the existence of a surplus out of which dividends might have been declared. On the other hand, dividend distributions under Sec. 115(a) are treated and taxed as *ordinary income* in the hands of the stockholder distributees.

This distinction between the ordinary dividend payment by a going corporation and a distribution in liquidation is dispositive of the issue here. In the Revenue Act of 1936 Congress' awareness of the distinction moved it to add Sec. 27(f) (now 27(g)) to the existing provisions to provide relief in the form of a dividends paid credit for distributions in liquidation out of accumulated earnings or profits.[5] At the same time the definition of "dividend" in Sec. 115(a) was expanded to include distributions "out of the earnings or profits for the taxable year . . . without regard to the amount of the earnings or profits at the time the distribution was made." Both of these amendments were included to facilitate allowance of a dividends paid credit in computing the newly imposed undistributed profits tax which was later repealed.[6] The desired result

[5] Revenue Act of 1936, 49 Stat. 1648.

[6] Section 14 of the Revenue Act of 1936 imposed this tax in the form of a surtax on undistributed profits in order to tax corporations on income and distributed to stockholders in the form of taxable dividends. Despite the later repeal of this tax, provisions relating to allowance of the dividends paid credit were retained for purposes of applying the credit to exactions similar to the undistributed profits tax.

With respect to Sec. 27(f), the Report of the Subcommittee of the Committee on Ways and Means Relative to Proposed Tax Revision, 74th Cong., 2d Sess. 6 (1936), stated:

> "In computing undistributed net income, it is recommended that the corporation be allowed a deduction for any part of liquidating dividends properly allocable to earnings and profits, but no deduction shall be given for the portion thereof properly chargeable for capital account."

could only be attained by changing the statute with respect to the previously recognized types of corporate distribution, the ordinary dividend of the going corporation and the distribution in liquidation. We can maintain this established distinction by application of explicit provisons relating to liquidating distributions to the distribution here. Section 27(g) expressly provides the standards by which a corporation in liquidation may be granted the dividends paid credit. Since taxpayer's deficit in earnings or profits accumulated after February 28, 1913, was in excess of the amount distributed in liquidation, no part of the distribution is "properly chargeable to the earnings or profits accumulated after February 28, 1913." Thus the claimed dividends paid credit was properly disallowed by the Commissioner.

Taxpayer urges that Sec. 27(g) is of general application since it does not deal specifically with personal holding companies whereas Sec. 115(a) does deal directly with personal holding companies and specifically states that a different and broader definition of "dividend" is to be used in the case of a personal holding company than in the case of an ordinary business corporation. We need only refer to the dominating distinction discussed above. In broadening the definition of dividend to include "any distribution" by a personal holding company to its stockholders,[7] the legislative committees were explicit that the distributions by a personal holding company to stockholders did not encompass distributions in liquidation. H.R. Rep. No. 2333, 77th Cong., 2d Sess. 130-131 (1942-2 Cum. Bull. 372, 473);[8]

[7] Revenue Act of 1942, Sec. 186(a), 56 Stat. 798.

[8] Said the House Committee:

> "The amendments made by this section provide that any distribution to shareholders (*not in complete or partial liquidation*) made on or after the date of enactment of this act by a corporation which, for the taxable year in which such a distribution is made. . . . was under the applicable law a personal holding company, will now constitute a taxable dividend even if not paid out of accumulated or current earnings or profits." [Emphasis supplied.]

The Senate Committee Report contained identical language.

S. Rep. No. 1631, 77th Cong., 2d Sess. 177 (1942-2 Cum. Bull. 504.634).

Pembroke Realty & Securities Corp. v. Commissioner, supra, is cited by the taxpayer as authority for the proposition that application of Sec. 27(g) to the liquidation distribution does not bar allowance of the dividends paid credit. In the *Pembroke* case the Second Circuit concluded that an impairment of capital would not prevent allowance of a dividends paid credit against a distribution in liquidation out of current earnings or profits. In accord are Piper v. United States, 50 F. Supp. 363 (D. Minn. 1943), and Fisher v. Kavanagh, 100 F. Supp. 248 (E.D. Mich. 1951). On the basis of the *Pembroke* decision it is urged a dividends paid credit is allowable despite the existence of a capital impairment since the distribution by taxpayer was not in excess of current earnings and may properly be charged to the "earnings or profits accumulated after February 28, 1913". The *Pembroke* holding expanded the meaning of distributions "out of earnings or profits accumulated after February 28, 1913" to include distributions out of current earnings.[9] Such a holding, in our opinion, is contrary to the settled meaning of this phrase. See Foley Securities Corp. v. Commissioner, 106 F. 2d 731 (8th Cir. 1939), and cases cited; Van Norman Co. v. Welch, 141 F. 2d 99 (1st Cir. 1944); Fowler Bros. & Cox v. Commissioner, 138 F. 2d 774 (6th Cir. 1943); Commissioner v. W. S. Farish & Co., 104 F. 2d 833 (5th Cir.), cert. den. 308 U.S. 559 (1939); cf. Helvering v. Credit Alliance Corp., 316 U.S. 107, 111 (1942).

We think the correct rule is stated in Helvering v. Credit Alliance Corp., supra at page 111, where the Court,

[9] At the time of the liquidation in the *Pembroke* case (1936), Sec. 1115(a) contained only one definition of a dividend. Despite the fact that dividends were restricted to distributions "out of earnings or profits accumulated after February 28, 1913", the court declared that carrying over the settled meaning of this phrase to the personal holding company section would result in "consequences contradictory to the purposes of that section". (at page 254.) Compare Sec. 507(a) of the Code which provides: "The terms used in this subchapter shall have the same meaning as when used in chapter 1."

in discussing another facet of a problem involving application of Section 27(g) (then 27(f)) stated:

> "Section 27 deals with a credit to the distributing corporation and *the phrase finds its proper office in limiting the amount of the distribution in liquidation which may be considered a dividend from earnings or profits as distinguished from one composed of capital.*" (emphasis supplied)

This principle has been applied in Shellabarger Grain Products Co. v. Commissioner, 146 F. 2d 177 (7th Cir. 1944); and Addressograph-Multigraph Corp., 4 CCH Tax Ct. Mem. 147, Issue X, 184 (1945); cf. Foley Securities Corp. v. Commissioner, supra; Brooklyn National Corp. v. Commissioner, 5 T.C. 892 (1945), aff'd, 157 F. 2d 450 (2d Cir.), cert. denied, 329 U.S. 733 (1946).

The Government's view of the statute is further supported by the administrative regulations interpreting the pertinent section. U.S. Treas. Reg. 111, Sec. 29.27(g)-1(a) provides:

> "To the general rule that an allowance for dividends paid is permitted only with respect to taxable dividends paid, section 27(g) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Internal Revenue Code, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913."

The amount "properly chargeable to the earnings or profits accumulated after February 28, 1913" is determined by deducting ". . . from the amount of the distribution that part allocable to capital account". U.S. Treas. Reg. 111, 29.27(g)-1(b). Recognizing the settled distinction between the ordinary dividend and the liquidating distribution, the interpretative regulations promulgated under Section 115(a) provide that "(t)he term 'dividend' does not include distributions under Section 115(c), relating to distributions in liquidation . . ." U.S. Treas. Reg. 111, Sec. 29.115-1.

I.T. 3067, 1937-1 Cum. Bull. 91, published in 1937, holds on facts similar to these ". . . that in the case of a complete liquidation of a corporation no income remains undistributed and, therefore, there is nothing to which the undistributed profits tax is applicable." While the logic of this conclusion appears sound, we find nothing in the Code to support such a result so that we are not bound by this opinion. Cf. Hackett v. Commissioner, 159 F. 2d 121 (1st Cir. 1946). In view of the decisions in the *Shellabarger* and *Addressograph-Multigraph* cases, supra, the Internal Revenue Service has revoked its former ruling and now holds:

> ". . . a corporation, with impaired capital, should be allowed a dividends paid credit within the meaning of section 27(g) of the Internal Revenue Code only to the extent that distributions in complete or partial liquidation from current year's earnings exceed the existing deficit."[10]

It is recognized that Congress imposed the prohibitive surtax on personal holding companies to destroy the tax advantages accruing to such companies, and to drive them out of business. Since complete liquidation accomplished the desired result in this case, taxpayer urges that imposition of the tax would be contrary to the intent of Congress and destructive of the purpose of the personal holding company provisions. The District Court points out the inequity of imposing the surtax on taxpayer in this situation in 134 F. Supp. 411, at page 415:

> "The overriding intent of Congress, it would seem, was, that insofar as personal holding companies are concerned, to compel such companies to distribute the funds on hand and to prevent their accumulation or to compel substantial surtaxes on such accumulation. There seems no discernible intent to discriminate against a company unsuccessful in past years as against one which had had some measure of success, when in both cases the overriding purpose of Congress, viz., the distribution of all funds, is accomplished."

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[10] Rev. Rul. 54-71, 1954-1 Cum. Bull. 71, 72.

See also Pembroke Realty & Securities Corp. v. Commissioner, supra at page 254, and Piper v. United States, supra at page 365.

However, arguments based upon inequity are beyond judicial cognizance where the statute does not remedy the inequity, nor can we extend the meaning of the statute to embrace matters for which no provision has been made. The Supreme Court has affirmed this principle in United States v. Olympic Radio & Television, Inc., 349 U.S. 232, 236 (1955), where it said:

> "This taxpayer argues the inequity of the results which would follow from our construction of the Code. But as we have said before, 'general equitable considerations' do not control the question of what deductions are permissible. Deputy v. du Pont, supra, at 493. It may be that Congress granted less than some thought or less than was originally intended. We can only take the Code as we find it and give it as great an internal symmetry and consistency as its words permit."

The Revenue Acts enacting the various Internal Revenue Codes and the amendments thereto have been the results of constant scrutiny and experience under previous Acts. Efforts are made continuously, on the one side, to close the gaps through which taxpayers have escaped untaxed, and, on the other to provide relief for the taxpayer in a hardship position. Corrective legislation with respect to the taxing statute has been the continuous duty of the legislative branch. Certain areas of the Code have been phrased in broad terms which sometimes prove provocative of judicial legislation. However, detailed sections of the Code have left little room for the engraftment of judicial addenda to the end of making a "better" statute. A more literal interpretation of the statute consistent with the established meaning of the previously used legislative wording is the only method compatible with such detail. The provisions of the Code relating to the personal holding company present a detailed procedure for determining the amount of surtax imposed upon these entities singled out by Congress for burdensome tax treatment. The detail and strictness of the provisions have resulted in hardship and

apparent inequity in several situations. See American Package Corp. v. Commissioner, 125 F. 2d 413 (4th Cir. 1942); Noteman v. Welch, 108 F. 2d 206 (1st Cir. 1939); Foley Securities Corp. v. Commissioner, supra; Saxon Trading Corp. v. Commissioner, 45 B.T.A. 16 (1941); cf. Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46 (1940). Relief of hardship requires legislative correction not judicial legislation. We think the reasoning of the Supreme Court in Crooks v. Harrelson, 282 U.S. 55 (1930), at page 60, is singularly appropriate:

> "Courts have sometimes exercised a high degree of ingenuity in the effort to find justification for wrenching from the words of a statute a meaning which literally they did not bear in order to escape consequences thought to be absurd or to entail great hardship. But an application of the principle so nearly approaches the boundary between the exercise of the judicial power and that of the legislative power as to call rather for great caution and circumspection in order to avoid usurpation of the latter. Monson v. Chester, 22 Pick. 385, 387. It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts."[11]

We once observed that the personal holding company provisions of the Code pronounced the "death sentence" against the use of such corporations. Sanford Corp. v. Commissioner, 106 F. 2d 882, 883 (1939), cert. denied, 309 U.S. 659 (1940). At times the execution is grievously painful.

For the reasons stated the judgment of the District Court will be reversed with directions to proceed in accordance with this opinion.

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[11] See Int. Rev. Code of 1954, Sec. 562, for the legislative answer to this problem.

APPENDIX B

OPINION OF THE DISTRICT COURT

RODNEY, *District Judge.*

This matter involves a construction of a complicated series of statutory provisions of the Revenue Code as applicable to personal holding companies. No findings of fact are required as the parties have stipulated all the pertinent facts and the difficulty arises from the necessity of correlating the maze of diverse statutory provisions to ascertain the intent of Congress.

The jurisdiction of this Court is based on 28 U. S. C. §1346(a)(1).

The determination of the present difficulty involves the following facts. The St. Louis Company is, or was prior to its dissolution, a personal holding company. A personal holding company is an entity originating under the revenue acts providing for excess profits taxes where earnings were not distributed or were unduly reserved. It has been utilized by persons of substantial means to minimize the tax on income and has been termed "an incorporated pocket book" and for these companies Congress has provided for both normal and drastic surtax with certain complicated deductions. Among the distinguishing features of a personal holding company is the extremely limited number of stockholders. In the present case it appears that at the time of dissolution all of the stock of the plaintiff company was held by the executors of only one named person.

On or about July 1, 1948, the plaintiff filed in the Office of the Collector of Internal Revenue at Wilmington, Delaware its personal holding company tax return for the fiscal year of July 1, 1947-June 30, 1948 and paid the alternative tax shown by said return to be due. Upon an audit of the return a deficiency was alleged and an additional tax of $31,540.29 was assessed. This assessment was paid September 14, 1950 together with interest from September 15, 1948 amounting to $3,583.49. A refund of these amounts

was demanded and refused on March 30, 1951. This suit for such refund followed on March 20, 1953.

On or about June 14, 1948, the plaintiff was dissolved under the Delaware law, and on March 25, 1953 a receiver was appointed for the purpose of instituting and prosecuting the claim for refund as above outlined, and such suit was brought on March 26, 1953, and is now pending in this Court as Civil Action No. 1529. It is stipulated that the two suits involve the same facts and seek the same relief and that a determination in this case will control the determination of the other.

Two further facts remain to be stated for it is concerning them that most of the difficulties arise. It is stipulated that for the fiscal year ending June 30, 1948 the plaintiff company had earnings and profits, after taxes, of $37,766.62. It is also stipulated that on July 1, 1947 there was a deficit in the accumulated earnings and profits of $121,436.24 and that on June 18, 1948, the date of distribution in complete liquidation, the deficit amounted to $82,001.86.

The question, generally, comes down to this. The plaintiff in its return claimed and now claims that the sum of $37,766.62, being the net earnings for the fiscal year 1947-1948 and which amount was distributed in total dissolution, constituted a dividends paid credit within the terms of the Act and this credit being allowed, the alternative tax should have been $8.50 as reported. The plaintiff contends that the net earnings of $37,766.62, distributed as stated, constitutes a dividends paid credit, regardless of the accumulated deficit of earnings and profits shown at the beginning of the fiscal year in question.

The defendant, on the other hand, contends that the net earnings and profits for the fiscal year and amounting to $37,766.62 cannot, in view of the accumulated deficit of earnings and profits of $121,436.24, be allowed in total dissolution as a dividends paid credit and that said amount of $37,766.62 constituted undistributed net income in computing taxpayers alternative personal holding company tax. The deficiency was thus computed as $31,540.29.

It will be borne in mind, and in view of subsequent statutory provisions, that the present case is to be determined by the state of the law as it existed at the time the facts occurred, viz., in 1948, being largely the Revenue Act of 1939 as amended to 1948.

The plaintiff by a series of related steps seeks to trace through the statutes the conclusion that the tax return as filed by it was correct and subsequent additional assessment against it by the Collector was erroneous. Thus, the plaintiff by detailed steps argues:

Sec. 501 of Sub-chapter A defines a personal holding company. Since there is no dispute as to the status of the plaintiff as such personal holding company, this section will not be further considered.

Section 500 provides a surtax on undistributed Chapter A net income (in addition to the taxes imposed by Chapter 1).

Sec. 505 defines the net income. With this we are not concerned since our problem concerns solely the "undistributed" net income as set out in Sec. 504.

Sec. 504 provides that the "undistributed Sub-chapter A net income" means the net income as set out in Sec. 505 less certain items of which we are only concerned with the item "the amount of the dividends paid credit set out in Section 27(a) * * *".

Sec. 27(a) defines a "dividends paid credit" as the sum of several items of which we are only concerned with "(1) the basic surtax credit for such year computed as provided in subsection (b)".

Sec. 27(b) defines a "basic surtax credit" as the sum of certain items including "The dividends paid during the taxable year * * *".

Sec. 115 defines dividends. Originally the Section had only one definition, viz., "the term dividend when used in this chapter * * * means any distribution made by a corporation to its shareholders * * * out of its earnings or

profits accumulated after February 28, 1913".[1] In 1936 a further definition was added by which a "dividend" was embraced within any distribution "out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made."

In 1942 an additional reference to dividends was added to Sec. 115(a), being peculiarly and solely applicable to personal holding companies. Such additional definition was substantially "In the case of a corporation * * * [personal holding company] such term [dividend] also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or other property to the extent of its Sub-chapter A net income, less [certain matters not here material]."

While the Personal Holding Company tax is levied under Sub-chapter A and the definitions of dividends are shown in Section 115(a) of Chapter 1, yet Section 507(a) of Sub-chapter A expressly provides that the terms used in this Sub-chapter shall have the same meaning as when used in Chapter 1.

Such, in effect, are the statutory provisions relied upon by the plaintiff.

The defendant (Government) agrees that if the sequence of statutory enactments as outlined by the plaintiff be accepted, and if the definition of dividends be determined by Sec. 115(a) alone, that the plaintiff would be entitled to the refund. The defendant insists, however, that such sections are not controlling but that the matter is to be determined by a consideration of Section 27(g). This section provides:

> "In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purpose of computing the basic surtax credit under this section, be treated as a taxable dividend paid."

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[1] This was the provision when Pembroke Realty & S. Corp. v. Commissioner, 122 F. 2d 252, was determined.

The defendant, generally, contends that with an impairment of capital and a deficit at the beginning of the taxable year, there can be no earnings or profits accumulated from or on account of which dividends could be paid or a "dividend paid credit" could be credited.

The end to be attained is to ascertain the intent of Congress, The Government points out that when the amendments were made to Section 115(a) that no similar or mutual amendments were made to Section 27(g).

The Government, in short, contends that distributions in liquidation are solely brought about by Sec. 115(c); that when total liquidation proceedings are had pursuant to Section 115(c), we then must look to Sec. 27(g) for the ascertainment of the surtax credit and taxable dividend paid. The Government contends that while the amendments of 1936 and 1942 to Sec. 115(a) gave to the term "dividends" a wider latitude, yet since no similar amendments were made to 27(g) and since by the latter section the only criterion is accumulated earnings or profits since February 28, 1913, and that with the admitted deficit sustained by the company there are no accumulated earnings, so the plaintiff cannot prevail.

Matters almost exactly similar to the present question have been before the Courts on several occasions. In Pembroke Realty & Securities Corporation v. Commissioner, 122 F. 2d 252 (2nd Cir. 1941), the Court considered the statutes prior to the amendments to Sec. 115(a) of 1936 and 1942. Sec. 115(a) then had only one definition of a dividend, viz., a distribution made out of earnings and profits accumulated since February 28, 1913, the exact provision as contained in Sec. 27(g), so strongly relied upon by the Government. The Court, consisting of Judges Learned Hand, Augustus Hand and Swan, unanimously concluded that the company in complete liquidation was entitled to the credit regardless of the fact that its capital was impaired.

The same result was reached in Piper v. United States, 50 F. Supp. 363 (Minn. 1943) and Fisher v. Kavanagh, 100 F. Supp. 248 (E. D. Mich. 1951).

The Government strongly relies upon Shellabarger Grain Products Co. v. Commissioner, 146 F. 2d 177. This was a case of partial liquidation and Congress seems to have sharply distinguished between complete liquidation, as the present case, and matters in partial liquidation, and to have laid down different rules for their governance. At any rate, the reasoning of the Pembroke, Piper and Fisher cases appeal more strongly and are unaffected by the Shellabarger case.

The Government, however, contends that the Pembroke and Piper cases were determined before the promulgation of Income Tax Regulation 111, Sec. 29.115-1 (Oct. 26, 1943 as amended June 6, 1944 by T. D. 5377). The Government contends that had this regulation been in force the conclusions reached may have been different. Fisher v. Kavanagh, 100 F. Supp. 248 was decided in 1951 after the promulgation of the regulation. The regulation seems to apply to Sec. 115 in its entirety, both sub-sections (a) and (c). It refers expressly to "personal holding companies" and mentions expressly Sec. 115(a). The regulation contains the definition of "dividend" as set out in Sec. 115(a), but does say that "the term dividend does not include the distribution under Sec. 115(c) relating to distributions in liquidation".

While it is true that a regulation by a department of Government addressed to and reasonably adapted to the enforcement of an Act of Congress, the administration of which is confided to such department, has the force and effect of law if it be not in conflict with express statutory provision,[2] yet the power to enact regulations is not power to alter the law and the regulations have no power to amend or change existing statutory provisions.[3]

If the existing statutory law entitled the plaintiff to the relief sought, as held by the Pembroke and Piper cases, then the subsequent promulgation of the Regulation 111, Sec. 29.115-1, if contrary to that law, would not be adapted to the enforcement of that law but would be an ineffective

[2] Maryland Casualty Co. v. United States, 251 U. S. 342, 349.
[3] U. S. v. Two Hundred Barrels of Whiskey, 95 U. S. 571, 576.

opposition to the statutory law. As said in Independent Petroleum Corporation v. Fly, 141 F. 2d 189:

> "The power to make regulations does not extend to making taxpayers of those whom the act, properly construed, does not tax."

I do not think the terms of Regulation 111, Sec. 29.115-1 are dispositive of the questions here presented.

Upon the merits of the case, certain things seem clear. The plaintiff company for the fiscal year in question had earnings and profits of a considerable sum. On these earnings the corporation paid the usual corporation tax, and the question in the present case involves the disposition of the remainder of such earnings.

All of the authorities agree that the underlying purpose of Congress in imposing a surtax of 75% or 85% on the undistributed earnings of personal holding corporations was to compel the distribution of these earnings, so that such earnings would be liable to other provisions of the tax law. In the present case it is clear that by a complete liquidation the present plaintiff has gotten into the hands of its stockholders all of the property of the company including its current earnings, and the whole purpose of the law has been carried out.

The Government tacitly concedes, insofar as the facts of the case are concerned, if the plaintiff company on July 1, 1947 had no deficit but accumulated earnings of even an infinitesimal amount and during the ensuing year had made profits, that then on dissolution the company could have distributed the current earnings as dividends and been entitled to the "dividend paid credit". It must equally be true, it seems, that if the company on July 1, 1947 had no deficit and no accumulated earnings whatever, that the same result would follow as to current earnings upon total dissolution and distribution.

The overriding intent of Congress, it would seem, was, that insofar as personal holding companies are concerned, to compel such companies to distribute the funds on hand and to prevent their accumulation or to compel substantial

surtaxes on such accumulation. There seems no discernible intent to discriminate against a company unsuccessful in past years as against one which had had some measure of success, when in both cases the overriding purpose of Congress, viz., the distribution of all funds, is accomplished. As stated in Fisher v. Kavanagh (supra), the position of the taxing authority would seem to achieve a result completely repugnant to the purposes of the Act.

It is not without interest that during all the years in question the Income Tax Division of the Bureau of Internal Revenue by a directive agreed with the contention of the plaintiff. From 1937 until 1954, almost a year after this case commenced, there existed this directive clearly outlining the position of the Government. In 1937, by the directive called I. T. 3067, there was recited an instance strongly analogous to the present case. After reciting all the facts, the Department concluded that the Act:

> "* * * imposes a surtax on undistributed profits. The surtax is measured by the 'undistributed net income' of the corporation. Congress contemplated in the enactment of the statute an accumulation of current profits retained in fact by the corporation, a current accumulation withheld by the corporation from distribution to shareholders. It is obvious that in the case of a complete liquidation of a corporation no income remains undistributed and therefore there is nothing to which the undistributed profits tax is applicable. In this situation it is immaterial whether the prescribed distribution takes the form of an ordinary dividend or a distribution in liquidation. In view of the above it is held that in the case of the complete liquidation of the M corporation the corporation is entitled to a dividends paid credit for the year 1936 to the full extent of the earnings and profits for that year which were distributed, regardless of the fact that the corporation had an operating deficit at the beginning of the taxable year in excess of the earnings and profits for that year."

It may be true that the directive did not have the force of law, but it was the announced position and thought of

the Government at the time and under the terms of which the plaintiff liquidated and was dissolved. For over seven years and until after this suit was brought, the Government clearly announced this as its understanding of the law. With this I am in accord and the plaintiff should, I think, prevail.

Appropriate orders or forms of judgment may be submitted covering this case and the companion case, Civil Action No. 1529.

/s/ RICHARD S. RODNEY

At: Wilmington, Del.
Dated: July 28, 1955.

FINAL JUDGMENT

AND Now, to wit, on this 15th day of September, A. D. 1955, this matter having come on for final hearing before the Court on a Stipulation of Facts entered into by the parties, and the Court having heard, read and considered the oral arguments and Briefs of the parties and having rendered its written opinion thereon dated the 28th day of July, A. D. 1955, now, therefore, for the reasons stated in said opinion,

IT IS ORDERED that final Judgment be, and it hereby is, entered in favor of the Plaintiff and against the Defendant in the amount of THIRTY-FIVE THOUSAND, ONE HUNDRED AND TWENTY-THREE DOLLARS AND SEVENTY-EIGHT CENTS ($35,123.78), plus interest on such amount at the rate of six per centum (6%) per annum from the Fourteenth day of September, A. D. 1950, to a date which will precede the date of the refund check by not more than thirty days, such date to be determined by the Commissioner of Internal Revenue, and

IT IS FURTHER ORDERED that each party shall pay its own costs of this proceeding.

/s/ RICHARD S. RODNEY,
Judge.

Approved as to form: September 15, 1955.
/s/ LEONARD G. HAGNER

APPENDIX C

Revenue Code of 1939:

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in General.* — As used in this chapter with respect to any taxable year the term "dividends paid credit" means the sum of:

(1) The basic surtax credit for such year, computed as provided by subsection (b);

(b) *Basic Surtax Credit.* — As used in this chapter the term "basic surtax credit" means the sum of:

(1) The dividends paid during the taxable year, * * *.

* * * * * *

(g) *Distributions in Liquidation.* — In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid.

(26 U. S. C. 1952 ed., Sec. 27.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Section 186, Revenue Act of 1942, c. 619, 56 Stat. 798, and Section 1, Act of June 25, 1947, c. 144, 61 Stat. 179] *Definition of Dividend.* — The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its stockholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. In the case of a corporation which, under the law applicable to the taxable year in

which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504(c) or section 506, or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income, less the sum of the following:

(1) The net operating loss credit provided in section 26(c)(1);

(2) The dividend carry-over provided in section 27(c);

(3) The deduction for amounts for retirement of indebtedness provided in section 504(b).

(26 U. S. C. 1952 ed., Sec. 115.)

SEC. 500. [As amended by Section 181, Revenue Act of 1942, *supra*]. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof not in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

(26 U. S. C. 1952 ed., Sec. 500.)

SEC. 504. UNDISTRIBUTED SUBCHAPTER A NET INCOME.

For the purpose of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) minus—

(a) The amount of the dividends paid credit provided in section 27(a) * * * .

* * * * * *

(26 U. S. C. 1952 ed., Sec. 504.)

REGULATIONS 111, SECTION 29.115-1

SEC. 29.115-1 [As amended by T. D. 5377, 1944 Cum. Bull. 257]. DIVIDENDS. — The term "dividend" for the purpose of chapter 1 (except when used in section 201(c)(5), section 204(c)(11), and section 207(a)(2) and (b)(3) where the reference is to dividends of insurance companies paid to policyholders) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

The term "dividend" also includes any distribution to shareholders to the extent of its Subchapter A net

income for the taxable year as hereinafter indicated in which, or with respect to which, the distribution is made, whether or not a dividend as defined in the first sentence of section 115(a), made by a corporation which, for the taxable year in which such a distribution is made or for the taxable year in respect of which it is made under section 504(c), relating to dividends paid within two and one-half months after the close of the taxable year, or section 506, relating to deficiency dividends, or corresponding provisions of a prior income tax law, was under the applicable law a personal holding company. Such a distribution, if made on or after October 21, 1942 (see section 186(g) of the Revenue Act of 1942 which is set forth immediately preceding section 29.504-1), will constitute a taxable dividend even if not paid out of accumulated or current earnings or profits. The term "dividend" does not include distributions under section 115(c), relating to distributions in liquidation, section 115(e), relating to distributions by personal service corporations, and section 115(f), relating to stock dividends. For treatment of any distribution made prior to October 21, 1942, which is a dividend solely by reason of the last sentence of section 115(a), see section 29.504-3.

* * * * * *

INCOME TAX RULING, 3067, 1937-1-C.B.-91

SECTION 27(f) — CORPORATION CREDIT FOR DIVIDENDS PAID: DISTRIBUTIONS IN LIQUIDATION

XVI-16-8647
I. T. 3067

Article 27(f) — 1: Dividends paid credit for distributions in liquidation.

REVENUE ACT OF 1936

The M Corporation, which was completely liquidated in 1936, is entitled to a dividends paid credit under Section 27(f) of the Revenue Act of 1936 to the full extent of the earnings and profits for that

year which were distributed, regardless of the fact that the corporation had an operating deficit at the beginning of the taxable year in excess of the earnings and profits for that year.

Advice is requested whether the M Corporation upon its liquidation in the year 1936 is entitled to a dividends paid Credit under section 27(f) of the Revenue Act of 1936 where its operating deficit at the beginning of the year 1936 exceeded its earnings and profits for that year to the date of liquidation. It is stated that in the liquidation of the M Corporation in the year 1936 all assets, including earnings for that year, were distributed to shareholders, that no part of the assets was transferred to another corporation, and the M Corporation discontinued operations in that year.

Section 27(f) of the Revenue Act of 1936 provides that:

> (f) *Distributions in liquidation* — In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.

Section 14 of the Act imposes a surtax on *undistributed* profits. That surtax is measured by the "*undistributed* net income" of the corporation. Congress contemplated in the enactment of the statute an accumulation of current profits retained in fact by the corporation, a current accumulation withheld by the corporation from distribution to shareholders. It is obvious that in the case of a complete liquidation of a corporation no income remains undistributed and, therefore, there is nothing to which the undistributed profits tax is applicable. In this situation it is immaterial whether the prescribed distribution takes the form of an ordinary dividend or a distribution in liquidation.

In view of the above, it is held that in the case of the complete liquidation of the M Corporation the corporation is entitled to a dividends paid credit for the year 1936 to the full extent of the earnings and profits for that year which were distributed, regardless of the fact that the corporation had an operating deficit at the beginning of the taxable year in excess of the earnings and profits for that year.

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 645

THE ST. LOUIS COMPANY, A DELAWARE CORPORATION (IN DISSOLUTION), PETITIONER

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 13-23) is reported at 237 F. 2d 151. The opinion of the District Court (Pet. 24-32) is reported at 134 F. Supp. 411.

JURISDICTION

The judgment of the Court of Appeals was entered on September 24, 1956. The petition for a writ of certiorari was filed on December 21, 1956. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the court below was correct in ruling that a personal holding company, whose deficit in accumulated

earnings and profits exceeded its earnings and profits for the current taxable year, was not entitled to a dividends paid credit within the meaning of Section 27(g) of the Internal Revenue Code of 1939, on amounts distributed in its complete liquidation, inasmuch as no part of the distribution was properly chargeable to earnings and profits accumulated after February 28, 1913.

STATUTE AND REGULATIONS INVOLVED

Sections 27(a), (b) and (g), 115(a), (b) and (c), 500, 504 and 507 of the Internal Revenue Code of 1939, and Sections 29.27(g)-1, 29.115-1 and 29.115-5 of Treasury Regulations 111, are set forth in the Appendix, *infra*, pp. 13-20.

STATEMENT

All the facts were stipulated and may be summarized as follows:

On or about July 1, 1948, taxpayer, St. Louis Company, filed in the office of the Collector of Internal Revenue at Wilmington, Delaware, its federal personal holding company tax return, under Subchapter A, Chapter 2, of the Internal Revenue Code of 1939,[1] for the fiscal year July 1, 1947, to June 30 1948, and paid the alternative tax shown thereon to be due. The Commissioner, upon auditing the return, made certain adjustments in the computation of the alternative tax and determined a deficiency of $31,540.29 in the amount of the alternative tax due from the taxpayer for its fiscal year 1947-1948. Pursuant to this determination by the Commissioner, an additional tax was assessed and upon notice and demand the additional tax in the sum of $31,540.29 with interest from September 15,

[1] All references to "Internal Revenue Code" or "Code" are, unless otherwise noted, to the Internal Revenue Code of 1939.

1948, in the amount of $3,583.49, was paid by taxpayer on September 14, 1950. (Stip. par. 2, R. 10a.) [2] A claim for refund was duly filed by the taxpayer and disallowed on March 30, 1951. (Stip. par. 2, R. 10a-11a.)

Taxpayer had reported as its net income under Subchapter A, Chapter 2 of the Internal Revenue Code the sum of $37,766.62 and claimed for a dividends paid credit against the Subchapter A net income the sum of $37,766.62. Taxpayer thus reported no income subject to the surtax imposed under Subchapter A, Chapter 2, i.e., undistributed Subchapter A net income, and computed its alternative personal holding company tax to be $8.50. (Stip. par. 3, R. 11a.)

The Commissioner disallowed in full the asserted dividends paid credit of $37,766.62 and adjusted taxpayer's undistributed Subchapter A net income to $37,766.62, in computing taxpayer's alternative personal holding company tax. The Commissioner computed the taxpayer's alternative tax to be $31,548.79 and its deficiency to be $31,540.29. (Stip. par. 3, R. 11a.)

On or about June 18, 1948, taxpayer was dissolved under the laws of Delaware. On or about June 18, 1948 (but after July 1, 1947, and prior to June 30, 1948), taxpayer distributed all its assets, which were in excess of $37,766.62, to its sole stockholder. There were no other distributions by the taxpayer to its stockholder during its fiscal year ending June 30, 1948. The amount of taxpayer's earnings and profits, after taxes, for its fiscal year ended June 30, 1948, was $37,766.62. The amount of the deficit in taxpayer's accumulated earnings and profits on July 1, 1947, was $121,436.24 and on

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[2] Record references are to Appendix B to the brief for the United States in the Court of Appeals.

or about June 18, 1948 (the date of the distribution in complete liquidation), the deficit was $82,001.86. (Stip. par. 4, R. 11a-12a.)

The District Court entered judgment in favor of taxpayer (R. 23a), and upon appeal the Court of Appeals for the Third Circuit reversed the District Court's judgment. (Pet. 13-23).

ARGUMENT

The decision below is clearly correct and does not directly conflict with the decision of any other Court of Appeals. Contrary to the assertion of the taxpayer, the case does not involve a question of general importance but rather one of narrow application completely disposed of by subsequently enacted legislation.

1. The taxpayer is a personal holding company, which in the year of complete liquidation had a deficit in accumulated earnings and profits in excess of current earnings in the taxable year. The provisions of Subchapter A of Chapter 2, which relate specifically to personal holding companies are concededly applicable. Section 500 (Appendix, *infra,* pp. 15-16) provides for the imposition of a surtax upon the "undistributed subchapter A net income" of every personal holding company. Section 504 (Appendix, *infra,* p. 16) defines "undistributed subchapter A net income" as the Subchapter A net income (as defined in Section 505 (26 U.S.C. 1952 ed., Sec. 505)) minus, among other things, the amount of the dividends paid credit provided in Section 27(a) (Appendix, *infra,* p. 13). Section 507(a) (Appendix, *infra,* p. 16) provides that the terms used in Subchapter A of Chapter 2 shall have the same meaning as when used in Chapter 1. The present controversy turns upon the right of the taxpayer to claim the dividends paid credit.

Section 27(a) defines the "dividends paid credit" as including the "basic surtax credit" for such year, computed as provided in subsection (b). Subsection (b) (Appendix, *infra,* p. 13) defines the "basic surtax credit" as the sum of the dividends paid during the taxable year, adjusted for certain factors not here relevant. However, in this case there were no ordinary dividends paid by the taxpayer during the taxable year, rather it is agreed that the corporate distribution upon which the taxpayer relies was a distribution in complete liquidation. (Stip. par. 4, R. 11a-12a.) And Section 27(g) (Appendix, *infra,* p. 13) contains explicit direction for computation of the dividends paid credit in the case of liquidation distributions as follows:

> *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid.

It is the position of the Government that since the current earnings of this personal holding company were insufficient to wipe out its existing capital deficit, no part of the distribution is "properly chargeable to the earnings or profits accumulated after February 28, 1913," and taxpayer is not entitled to the dividends paid credit claimed.

The taxpayer contends, however, that the term "dividend" as defined in Section 115(a) of the Code (Appendix, *infra,* pp. 13-14) is controlling and that Section 27(g) is therefore inapplicable. However, Section 115 (a) of the Code has reference to dividend distributions of *going* corporations and the distribution here

involved is not of such type. On the contrary, it is concededly a liquidation distribution for which Section 115(c) (Appendix, *infra*, p. 15), makes express and different provision. Under Section 115(c), an amount distributed in complete liquidation is considered as an exchange of stock for cash or other property, and is treated as a capital gain or loss, rather than as income, in the hands of the distributees, despite the existence of a surplus out of which dividends might have been declared. On the other hand, dividend distributions under Section 115(a) are treated and taxed as ordinary income in the hands of the stockholder distributees. Thus, this distribution was not a dividend, in the proper sense of the term, and it may be treated as such only by specific statutory direction.

The role of Section 27 was considered by this Court in *Helvering* v. *Credit Alliance Corp.*, 316 U.S. 107, 110-111, where in discussing Section 27(f) (the predecessor to Code Section 27(g)), it was stated that—

> Although a distribution in liquidation of earnings which accrued subsequently to February 28, 1913, does not constitute a dividend in the proper sense of the term, subsection (f) categorically declares that a liquidating distribution, *to the extent it is composed of such earnings,* [italics supplied] shall, for the purposes of computing the dividends-paid credit *"be treated as a taxable dividend paid."*
> * * *
> Section 27 deals with a credit to the distributing corporation and the phrase finds its proper office *in limiting the amount of the distribution in liquidation which may be considered a dividend* [italics supplied] from earnings or profits as distinguished from one composed of capital.

In particular, the dividends paid credit authorized by Section 27 is plainly geared to the provisions of Section 115(a) and (c). Under Section 27(b)(1) the basic surtax credit relates to dividends distributed under Section 115(a). But Section 27(g) which refers to distributions in liquidation plainly contemplates the type of distribution explicitly provided for by Section 115(c), which like Section 27(g) is also entitled "Distributions in Liquidation." As to liquidation distributions Congress specifically directed that only such part properly chargeable to the earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend paid for the purpose of computing the basic surtax credit, i.e., the dividends paid credit. Yet it is clear that the distribution for which this taxpayer claims a credit was not paid out of earnings or profits accumulated after February 28, 1913, since indeed, there were no such earnings or profits during or at the end of the taxable year. And it is well settled that an impairment of capital must be restored out of subsequent earnings before there can be any accumulated earnings or profits. *Willcuts* v. *Milton Dairy Co.*, 275 U.S. 215; *Van Norman Co.* v. *Welch*, 141 F. 2d 99 (C.A. 1st).

The Court of Appeals for the Third Circuit correctly assessed the effect of the distinction between distributions of going corporations and distributions in liquidation when it held the difference to be dispositive of the issue at bar. The court noted (Pet. 17-18) that because Congress was aware of this distinction Section 27(f) (new Section 27(g)) was added to the Revenue Act of 1936, c. 690, 49 Stat. 1648, in order to provide relief in the form of a dividends paid credit for distributions in liquidation out of accumulated earnings or profits, while at the same time the definition of an

ordinary dividend in Section 115(a) was expanded to include distributions "out of earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made."

Congress dealt with the situation differently in the Internal Revenue Code of 1954. Section 562,[3] in setting forth the rules applicable in determining dividends eligible for the dividends paid deduction, specifically limits the right to such a deduction first, to the situation covered by Section 27(g) of the 1939 Code, *i.e.*, "the part of such distribution which is properly chargeable to earnings and profits accumulated after February 28, 1913, shall be treated as a dividend," and secondly, in addition allows such a deduction—

> In the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period

[3] SECTION 562. RULES APPLICABLE IN DETERMINING DIVIDENDS ELIGIBLE FOR DIVIDENDS PAID DEDUCTION.

(a) *General Rule.*—For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

(b) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation, the part of such distribution which is properly chargeable to earnings and profits accumulated after February 28, 1913, shall be treated as a dividend for purposes of computing the dividends paid deduction. In the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation, any distribution within such period pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend for purposes of computing the dividends paid deduction.

* * * * *

(26 U.S.C. 1952 ed., Supp. III, Sec. 562.)

> pursuant to such plan shall, to the extent of the earnings and profits (computed without regard to capital losses) of the corporation for the taxable year in which such distribution is made, be treated as a dividend * * *.

Thus, when Congress chose to express a rule different from Section 27(g) of the 1939 Code, it used different language. Moreover, the specific rule stated in the 1954 Code is different and more limited than the broad rule of interpretation for which the taxpayer here argues.

The following cases support the decision below: *Shellabarger Grain Products Co.* v. *Commissioner,* 146 F. 2d 177 (C.A. 7th); *Fowler Bros. & Cox* v. *Commissioner,* 138 F. 2d 774 (C.A. 6th); *Foley Securities Corp.* v. *Commissioner,* 106 F. 2d 731 (C.A. 8th). In the *Shellabarger* case the Court of Appeals affirmed the holding of the Tax Court (2 T.C. 75) and rulings of that tribunal repeatedly sustain the Government's contention. *Brooklyn National Corp.* v. *Commissioner,* 5 T.C. 892, affirmed, 157 F. 2d 450 (C.A. 2d), certiorari denied, 329 U.S. 733; *Addressograph-Multigraph Corp.* v. *Commissioner,* decided February 5, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,058, Issue X). As the court below noted, the legislative history of the relevant sections (Pet. 17-19), and the governing Treasury Regulations (Pet. 20) also lend support to the Government's contention. See Treasury Regulations 111, Sections 29.27(g)-1(a) and (b) and 29.115-1 (Appendix, *infra,* pp. 16-20).

While taxpayer urges upon this Court what it terms a "broad, economic method of interpretation" (Pet. 5), the precise and specific commands of the detailed governing provisions of the statute gainsay the conclusion

which taxpayer advocates. As the court below correctly points out (Pet. 22):

> * * * detailed sections of the Code have left little room for the engraftment of judicial addenda to the end of making a "better" statute. A more literal interpretation of the statute consistent with the established meaning of the previously used legislative wording is the only method compatible with such detail.

See *United States* v. *Olympic Radio & Television*, 349 U.S. 232, 236; *Crooks* v. *Harrelson*, 282 U.S. 55, 60.

2. Contrary to taxpayer's contention the decisions of the Court of Appeals for the Second Circuit in *Pembroke Realty & S. Corp.* v. *Commissioner*, 122 F. 2d 252, and *Brooklyn National Corp.* v. *Commissioner*, 157 F. 2d 450, are not in direct conflict with the decision below. While the *Pembroke* case expanded the meaning of distributions "out of * * * earnings or profits accumulated after February 28, 1913," to include distributions out of current earnings and, in the view of the court below (Pet. 19), this holding is contrary to the settled meaning of the phrase, *Pembroke* arose under the Revenue Act of 1934, c. 277, 48 Stat. 680, and involved immediately a construction of Section 115(a) of that Act. The present and more detailed structure of the statute, including the addition of Section 27(g) and the later amendments to Section 115(a), was not governing. Nor had the opinion of this Court in *Helvering* v. *Credit Alliance Corp., supra*, then been promulgated, construing the cognate of Section 27(g) and distinguishing between a dividend in the proper sense of the term on the one

hand, and that part of a distribution in liquidation which legislative fiat treats as a dividend from earnings and profits rather than a distribution of capital on the other. Also, the Treasury Regulation, *supra*, p. 9, upon which the court below properly relied (Pet. 20), was not yet in effect. Thus, in the *Pembroke* case the Second Circuit was dealing with a statute different in pattern and important detail and without the aids in construction afforded by later persuasive authorities.[4]

Again, in the *Brooklyn National* case, *supra*, while the majority of the court expressed adherence to its earlier reasoning in the *Pembroke* case, this was not the ground of the decision. Judge Learned Hand held that by reason of the rule in *Dobson* v. *Commissioner*, 320 U.S. 489, the Court of Appeals was bound to yield to the view of the Tax Court, which had rejected the *Pembroke* case; Judge Clark, concurring, agreed with the result *inter alia* because he did not regard the principle of the *Pembroke* case as correct "in view of the clear command of the statute." (157 F. 2d 450, 453.) Judge Augustus N. Hand dissented because he thought the Tax Court was wrong and that the *Dobson* rule did not require its affirmance.

In any event, in view of the fact that Section 562 of the Internal Revenue Code of 1954, *supra*, p. 8, has

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[4] In accord with *Pembroke* are *Piper* v. *United States*, 50 F. Supp. 363 (D. Minn.), and *Fisher* v. *Kavanagh*, 100 F. Supp. 248 (E.D. Mich.). The Commissioner originally also ruled that Section 27(f) of the 1936 Act allowed a dividends paid credit to the full extent of earnings and profits of the current year, regardless of the fact that a given corporation had an operating deficit at the beginning of the year in excess of the earnings and profits for the year. I. T. 3067, 1937-1 Cum. Bull. 91. However, in view of intervening litigation and the authorities above cited, this ruling was revoked. Rev. Rul. 54-71, 1954-1 Cum. Bull. 71.

settled for the future the issue here involved, this case does not present a question of sufficient general importance to warrant review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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JANUARY 1957.

APPENDIX

Internal Revenue Code of 1939:

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in General.*—As used in this chapter with respect to any taxable year the term "dividends paid credit" means the sum of:

(1) The basic surtax credit for such year, computed as provided in subsection (b);

* * * * *

(b) *Basic Surtax Credit.*—As used in this chapter the term "basic surtax credit" means the sum of:

(1) The dividends paid during the taxable year, * * *.

* * * * *

(g) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid.

* * * * *

(26 U. S. C. 1952 ed., Sec. 27.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Section 186, Revenue Act of 1942, c. 619, 56 Stat. 798, and Section 1, Act of June 25, 1947, c. 144, 61 Stat. 179] *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings

or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. In the case of a corporation which, under the law applicable to the taxable year in which the distribution is made, is a personal holding company, or which, for the taxable year in respect of which the distribution is made under section 504(c) or section 506 or a corresponding provision of a prior income-tax law, is a personal holding company under the law applicable to such taxable year, such term also means any distribution (whether or not a dividend as defined in the preceding sentence) to its shareholders, whether in money or in other property, to the extent of its subchapter A net income, less the sum of the following:

(1) The net operating loss credit provided in section 26 (c)(1);

(2) The dividend carry-over provided in section 27 (c); and

(3) The deduction for amounts for retirement of indebtedness provided in section 504 (b).

(b) [As amended by Section 186(b), Revenue Act of 1942, *supra*] *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been

distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113. The preceding sentence shall not apply to a distribution which is a dividend within the meaning of the last sentence of subsection (a).

(c) [As amended by Section 147, Revenue Act of 1942, *supra*] *Distributions in Liquidation.*— Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 115.)

SEC. 500 [As amended by Section 181, Revenue Act of 1942, *supra*]. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributable subchapter A net income of every personal holding company (in

addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof not in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

(26 U.S.C. 1952 ed., Sec. 500.)

SEC. 504. UNDISTRIBUTED SUBCHAPTER A NET INCOME.

For the purpose of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) minus—

(a) The amount of the dividends paid credit provided in section 27(a) * * *.

* * * * *

(26 U.S.C. 1952 ed., Sec. 504.)

SEC. 507. [As amended by Section 227(a), Revenue Act of 1939, c. 247, 53 Stat. 862]. MEANING OF TERMS USED.

(a) *General Rule.*—The terms used in this subchapter shall have the same meaning as when used in chapter 1.

* * * * *

(26 U.S.C. 1952 ed., Sec. 507.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.27(g)-1 [As amended by T. D. 5356, 1944 Cum. Bull. 220]. DIVIDENDS PAID CREDIT FOR DISTRIBUTIONS IN LIQUIDATION.—(a) *Distributions which diminish earnings or profits.*—To the general

rule that an allowance for dividends paid is permitted only with respect to taxable dividends paid, section 27(g) makes one exception, namely, for that part of an amount distributed in liquidation which, under the Internal Revenue Code, constitutes a distribution of, and is properly chargeable to, earnings or profits accumulated after February 28, 1913. Thus, a distribution either in complete or partial liquidation of a corporation is treated by the Code as one constituting in part a distribution of, and being properly chargeable to, earnings or profits, if—

(1) Under the provisions of section 115(c), the amounts distributed in liquidation are treated as received in payment for exchange for the stock; and

(2) Under the provisions of section 112, the gain or loss, if any, from such exchange is recognized or the gain is taxed as provided in section 112(b)(7).

In such a case, an allowance for dividends paid may be included in the basic surtax credit for the amount actually involved in such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, even though the method of taxation of the distribution is that ordinarily employed with respect to the gain or loss realized and recognized upon an exchange, rather than that employed with respect to a taxable dividend.

* * * * *

(b) *Amount properly chargeable to earnings or profits.*—In the case of a distribution in liquidation with respect to which an allowance for dividends paid is permissible (see paragraph (a) of this sec-

tion) the amount of the allowance is equal to the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings or profits accumulated since February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for purposes of these regulations, includes not only amounts representing the par or stated value of the stock with respect to which the liquidating distribution is being made but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings or profits accumulated since February 28, 1913. * * *

Sec. 29.115-1 [As amended by T. D. 5377, 1944 Cum. Bull. 257]. Dividends.—The term "dividend" for the purpose of chapter 1 (except when used in section 201(c)(5), section 204(c)(11), and section 207(a)(2) and (b)(3) where the reference is to dividends of insurance companies paid to policyholders) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or ac-

cumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

The term "dividend" also includes any distribution to shareholders to the extent of its Subchapter A net income for the taxable year as hereinafter indicated in which, or with respect to which, the distribution is made, whether or not a dividend as defined in the first sentence of section 115(a), made by a corporation which, for the taxable year in which such a distribution is made or for the taxable year in respect of which it is made under section 504(c), relating to dividends paid within two and one-half months after the close of the taxable year, or section 506, relating to deficiency dividends, or corresponding provisions of a prior income tax law, was under the applicable law a personal holding company. Such a distribution, if made on or after October 21, 1942 (see section 186(g) of the Revenue Act of 1942 which is set forth immediately preceding section 29.504-1), will constitute a taxable dividend even if not paid out of accumulated or current earnings or profits. The term "dividend" does not include distributions under section 115(c), relating to distributions in liquidation, section 115(e), relating to distributions by personal service corporations, and section 115(f), relating to stock divi-

dends. For treatment of any distribution made prior to October 21, 1942, which is a dividend solely by reason of the last sentence of section 115(a), see section 29.504-3.

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Sec. 29.115-5. Distributions in Liquidation.—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so cancelled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and section 29.111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112, and shall be subject to the conditions and limitations provided in section 117.

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